

Roundtable on Financing Water

The Roundtable on Financing Water

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Session 2. Blended finance for water-related investments

BACKGROUND PAPER

Draft

1.1. Blended finance: what potential for water-related investments?

Blended finance can play a critical role in mobilising commercial finance and strengthening the financing systems on which water and sanitation investments rely. The OECD DAC defines blended finance as the strategic use of development finance to mobilise additional finance towards sustainable development in developing countries (OECD, 2018). By deploying development finance in a way that addresses investment barriers to commercial capital in SDG-relevant sectors such as water and sanitation, blended finance operates as a market building instrument that provides a bridge from reliance on grant and other donor financing towards commercial finance. Blended finance can add value by contributing to shifting funds that are currently not directed to sustainable development in countries and sectors that have significant investment needs in order to deliver on the Sustainable Development Goals (SDGs). In doing so, blended finance enables the private sector to develop a track record of operating in the water sector by altering the risk-return balance to encourage the private sector to invest. Due to its transitory nature, over time blended finance should enable the recipient to rely less on development finance and more on commercial finance. At the same time, a greater role for commercial financing can enable stronger financial systems by encouraging accountability and transparency.

The OECD, with the support of the Swedish International Development Agency (SIDA), has undertaken research to better understand the current and potential role of blended finance models in water-related investments. The relevance of the sector for multiple SDGs shows that water-related investments can take a variety of forms and address a multitude of different needs. The scope of this research therefore takes a broad approach to water-related investment and covers blended finance models that contribute to the achievement of the SDGs including, but not limited to, SDG 6. Three sub-sectors were selected for more detailed analysis: (1) water and sanitation utilities, (2) off-grid sanitation and (3) multi-purpose water infrastructure (MPWI), including emerging landscape based approaches¹.

Based on findings from case studies, interviews, workshops and extensive desk research, this research seeks to build an understanding on how blended finance can play a role in attracting commercial finance. The forthcoming publication² will provide examples of current good practices and trends, distil lessons learned and emerging guidance to scale, and exploit the full potential of blended finance to deliver SDG 6.

This background note presents preliminary findings from that research. The first section provides an overview of the state of blended finance in water-related investment. The following section provides an outlook on the potential for blended finance and related recommendations. Several questions for discussion are set out at the end of the paper.

1.2. The state of blended finance in water and sanitation

1.2.1. Blended finance models are emerging but have not reached scale

Blended finance models to mobilise additional commercial finance in the water and sanitation sector are emerging but have not reached scale. Proven experience with blended finance varies by

¹ Landscape based approaches consider the impacts of investments within a given spatial area (e.g. catchment or basin) and often integrate nature-based solutions.

² To be launched at the Stockholm World Water Week in August 2019.

sub-sector (utilities, off-grid sanitation, multi-purpose infrastructure and landscape based approaches) given the heterogeneity of the operating models in each. Within this spectrum of blended financing, the three sub-sectors are characterised by transactions that reflect different stages of financial market building (see Figure 1).

Figure 1. Stylised representation of the current state of transaction level mobilisation and market evolution



Source: Author

Blended models to finance utilities are emerging as they are an appropriate tool for creditworthy or near creditworthy utilities to move away from purely concessional donor finance to more sustainable market financing. In the off-grid sanitation sector, however, grant and concessional financing is predominant, whereas blended finance models that mobilise commercial financing are largely absent at this stage. In contrast, MPWI is a sector where blended finance models are an established financing instrument mobilising commercial finance at scale. For landscape-based approaches, blended finance can potentially operate as a fit-for-purpose financing instrument as it brings together different stakeholders responding to their individual investment preferences, but developments of adequate business models remain at a very early stage.

1.2.2. A variety of blended finance instruments and mechanisms are already applied

The blended financing of water supply and sanitation utilities can take multiple forms in a variety of contexts. The case studies, interviews and research conducted for this OECD publication (forthcoming) revealed varied blending experiences with different instruments (credit lines, guarantees, grants, etc.) and contexts (urban and rural; large and smaller operators). It also revealed that blending can happen at multiple entry points in the financing chain, such as upstream at the level of the lender or utility (technical assistance, loans, credit lines, guarantees), or downstream to customers (utility-based pro-poor financing schemes; access to microfinance loans), and is often accompanied by technical assistance at all stages of the project.

For off-grid sanitation, grant funding appears to be the major source of finance, with philanthropic actors playing a major role. A few social impact investors provide patient capital in this sector. At the same time, grant funding appears to go to a handful of well-known social enterprises. The good practice examples of innovative business models examined in this research have received grant funding often from different international actors while, commercial finance from banks or investments from asset managers is largely absent. One exception is financing further downstream to customers, where microfinance can play a role in financing the access to sanitation services.

In the MPWI sector, blended finance models are an established financing instrument for typically large-scale special purpose companies directed to delivering multiple water-related benefits. Development actors engage in providing equity and debt to such companies, underwrite guarantees to mitigate risk for commercial investors, provide viability gap grant funding, or engage in project development with ambition to mobilise commercial financing. For landscape-based approaches, blended finance can potentially operate as a fit-for-purpose financing instrument as it brings together different stakeholders responding to their individual investment preferences. In particular, technical assistance and pooling mechanisms are prevalent blending instruments; models that mobilise commercial financing are at a very early stage.

1.3. The potential of blended finance in water and sanitation

1.3.1. Addressing operational bottlenecks can spur the uptake of blended finance instruments and mechanisms

Harness the opportunity to mobilise local commercial actors

Blended finance for water-related investments reinforces the need for and benefits from tailoring blended finance to the local context. Water supply and sanitation services are, by definition, locally sourced and provided. At the same time, the sector is highly regulated due to the public good nature of water supply and sanitation services. These characteristics emphasise the need to work closely with public authorities and local actors in order to align with local development needs. Landscape-based approaches in financing water resources management integrate and leverage the local perspective by definition. Local actors benefit from improved quality and reliability of water resources upon which local commercial players rely (e.g. agricultural producers, food and beverage companies, mining companies and other water-intensive industries).

Understand business models and revenue streams across the supply chain and develop matching blended finance approaches

The multiple ways water creates value offer a variety of entry points where revenues can be generated and which can be targeted by blended financing approaches.

The provision of sanitation services in developing countries is crucial for sustainable development but off-grid sanitation tends to be financially unattractive due to unstable and limited revenue generating capacity. However, complementary “treatment” businesses, such as faecal sludge collection and treatment service (“waste-to-energy”), constitute a more profitable business opportunity. Currently, philanthropic actors provide grant funding to the not-for-profit sanitation business pillar (usually the provision of toilets), and development finance institutions (DFIs) provide loans to the faecal sludge treatment and processing business. While the sale of outputs may still not cover a substantial portion of the operating sanitation budget (World Bank, 2019^[6]), blended concessional finance models may play a role in scaling integrated business models by valuing them across the supply chain.

Landscape-based approaches reassess the revenues and returns across the value chain to raise further types of financing. A rethinking of benefits and beneficiaries can create more profitable investment opportunities by generating often implicit returns (e.g. appreciation of land value), in addition to more explicit returns (e.g. a higher turnover or lower expenditures because of better watershed management in the area). Explicit gains can occur directly in the project company/investee but also indirectly within actors operating in the spatial areas. However, external financing would be needed to scale and replicate successful landscape models. That is, they need to realise explicit returns on investment, which can put an additional burden on the project or company in terms of capital expenditures. Alternatively, equity instruments can be a successful instrument to mobilise commercial investment for landscape-based approaches.

Explore the development of a portfolio of projects to address unfavourable project attributes

Providing commercial investors access to a variety of different transactions in the water and sanitation sector can mitigate concerns around small ticket size, risk exposure, limited sector or regional knowledge as well as high transaction costs. Pooling mechanisms such as blended finance funds tailor different risk and return profiles for individual investors, with development financiers often taking first loss and junior tranches buffering the risk for more commercial investors in the senior tranches. Guarantees can moreover strategically mitigate portfolio risk.

Design blended finance to build markets - and incorporate an approach for subsequent phasing out

Blended finance is a transitory market building tool that is designed to enable stand-alone commercial investment in the long-run, by providing confidence, capacities and a track record in markets where commercial investors are not yet investing. A discussion on phasing out should be integrated in any programme design, including in the water supply and sanitation utilities sub-sector. Water and sanitation utilities that are moving towards creditworthiness can benefit from the elaboration of well-targeted blended financing strategies, for instance in support of improving their operational efficiency and financial sustainability.

1.3.2. Policy level considerations to make blended finance work for SDG 6

Design blended finance in conjunction with efforts to improve the enabling environment

Blended finance instruments and approaches cannot replace efforts to establish a sound policy and regulatory framework that both water supply and sanitation services and water resource management require. Water and sanitation services are usually highly regulated due to the public good nature of services provided and the monopolistic characteristics of service provision. A weak enabling environment characterised by poorly designed or absent regulation, policies settings, and institutional arrangements constrains commercial investment. For utilities, providing the financing needed to upgrade and expand their services is necessary, but it is not sufficient to make a blended finance arrangement to work. Improving the enabling environment is equally important. In order to scale investments in water, policy-related bottlenecks have to be addressed.

Increase transparency to make a valid business case for commercial investment

Commercial investors are wary of uncertainty regarding any of the risks related to an investment opportunity. With adequate contractual arrangement or blended instruments and mechanisms, it is

possible to mitigate a variety of risks, share the remainder with the public sector or commercial co-investors, or take a certain level of risk on the financier's own book. However, in order to make such an assessment, risks associated with an investment should be transparent and hence quantifiable. For example, ex ante social and environmental risk assessments are inevitable to better understand the impact of large-scale MPWI projects. At the same time, such assessments are rather costly and lengthy. Development actors could engage in bringing their expertise to the table in conducting and financing such assessments.

In general, there is a need for more rigorous measurement, monitoring and evaluation of the development impacts of blended finance investments beyond the measurement of financial performances in order to prevent “impact” washing (OECD, 2019). The development impact of water and sanitation projects with their public good nature is often complex to assess, in particular in large-scale multi-purpose water infrastructure projects. There is no coherent and common approach to measure incremental, causal and attributed impacts of specific investments.

Establish co-ordination and co-operation processes for blended finance

A lack of co-operation among the various stakeholders in blended finance transactions and programmes can constitute a barrier for the broader uptake of blended finance. This includes co-ordination (1) across development and commercial players in blended finance transactions, but also more structurally (2) co-ordination among development finance actors to enhance co-operation on their engagements especially when a concessional element is involved. In terms of (1) co-ordination across stakeholders, all stakeholders should be part of the blended finance negotiations from the onset of the project. Due to differing interests in blended arrangements, it is important that commercial actors, including private entities and private financing institutions, are involved from the project preparation phase of the project, together with all other stakeholders. In addition, (2) development financiers should coordinate more structurally beyond single transactions. While there is general agreement about the need for improved cooperation, actions on the ground may remain fragmented. The development of sector financing strategies and also dedicated fora to discuss issues around concessionality and crowding-in commercial finance is needed.

Questions for discussion

1. In light of the preliminary findings presented above, what are your views regarding the assessment of the current state of blended finance for water and sanitation investments and the potential for scaling up?
2. Are there aspects relating to blended finance actors, instruments, and project attributes that should be better reflected in the analysis on the potential for blended finance?
3. Where do you see the most promising areas for further research and policy analysis on this topic?

References

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